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445140—42——1

In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 905

KEYSTONE AUTOMOBILE CLUB CASUALTY CO., PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

KEYSTONE AUTOMOBILE CLUB FIRE CO., PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The original opinion of the Board of Tax Appeals (R. 1) is reported in 40 B. T. A. 291, and the supplemental opinion (R. 77) is reported in 42 B. T. A. 356. The opinion of the Circuit Court

of Appeals (R. 304–312) is reported in 122 F. (2d) 886.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on September 10, 1941 (R. 312). A petition for rehearing was denied on October 30, 1941 (R. 328). The petition for a writ of certiorari was filed on January 27, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether petitioners should be taxed, solely as stock companies under Section 204 of the Revenue Act of 1934, or whether they are entitled to have their taxes computed under Section 207 relating to "mutual" companies.

2. Whether, even if Section 207 is applicable here, petitioners may deduct under Section 207 (c) (3) the net amount added annually to a so-called contingent reserve.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are set out in the Appendix, *infra,* pp. 13–23.

STATEMENT

The petitioners herein, Keystone Automobile Club Casualty Company and Keystone Automobile Club Fire Company, hereinafter referred to as the Casualty Company and the Fire Company, were

incorporated May 31, 1928, as stock corporations under the laws of the Commonwealth of Pennsylvania. The principal offices of the companies are in Philadelphia, Pennsylvania (R. 3).

The Keystone Automobile Club, referred to as the Club, a nonprofit corporation organized to promote the interests of motorists and furnishing many facilities to its members, desired to provide automobile casualty and fire insurance as an additional service to its members. With this end in view it caused the organization on March 23, 1925, of the Insurance Exchange of Keystone Automobile Club (R. 3–4).

The membership of the Club increased rapidly. It had many members in New Jersey. A reciprocal exchange was not permitted to operate in New Jersey. To accommodate its members in New Jersey, the Club organized the Casualty Company and the Fire Company as stock companies. Since a stock insurance company under the laws of Pennsylvania could not write both casualty insurance and fire insurance, it was necessary to incorporate two companies (R. 4). The articles of agreement of the two insurance companies provide that "The plan or principle on which the business is to be conducted is the joint stock plan or principle" (R. 117, 118).

The Club paid into the treasury of the Fire and Casualty Companies $450,000, the minimum capital requirements, for which it received the entire capital stock (R. 5).

It was originally planned that the insurance companies would pay dividends to its sole stockholder, the Club, until the $450,000 advanced by it, together with interest, had been returned but this program was subsequently abandoned. The Club's investment in the companies in the amount of $450,000 has always been carried on its books at that amount and it is the present expectation of the officers that upon any liquidation of the insurance companies the Club will receive only $450,000 (R. 5).

In November 1930 the statutory capital of the Casualty Company was increased from $200,000 to $300,000 and the statutory surplus from $100,000 to $150,000. At the same time the statutory capital of the Fire Company was increased from $100,000 to $200,000 and the statutory surplus from $50,000 to $100,000. These increases in the statutory capital and surplus of the two companies were made in order to meet the requirements of the Financial Responsibility Law of the State of New York. The increases were effected by the transfer of the necessary amounts from the contingent reserve of each company to the capital and surplus accounts. A stock dividend of $100,000 was declared by each company and additional shares of stock representing the stock dividends were issued to the Club (R. 5–6).

During the tax years involved, 1929–1935, the Fire and Casualty Companies insured members of

the Club and also members of two other automobile clubs, the Delaware Automobile Association and the Pittsburgh Motor Club. On the average they insured 35,121 of the 42,493 members of the Keystone Club and, in addition, 5,171 members of the other clubs who were not members of the Keystone Club. All policyholders were treated alike [1] (R. 7).

The members of the Keystone Club elected the Club's officers and directors and they in turn elected themselves, by proxy from the Club, officers and directors of the insurance companies. Policyholders of the other two clubs had no power to vote, although it was provided that they could become members of the Keystone Club upon payment of annual dues (R. 7).

Premium income, investment income and refunds made to policyholders during the taxable years and balance sheets as of the beginning and end of the taxable period are set forth in the record (R. 8–9).

The petitioners contended (1) that they were exempt from all taxation under the revenue acts [2]

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[1] The premiums were about 10 percent less than those charged by ordinary stock companies until 1932, and were 20 percent less thereafter. Moreover, until 1932, the policyholders received refunds of 25 percent of the premiums, and 10 percent thereafter (R. 6).

[2] Petitioners claimed exemption under Section 101 (11) of the 1934 Act and the corresponding provisions in Sections 103 (11) of the Revenue Acts of 1928 and 1932. See Appendix, *infra*, p. 13.

and (2) that even if subject to tax their taxable income was completely offset by allowable deductions. The Commissioner ruled that petitioners were not exempt, but he allowed them a variety of deductions that were carried on their balance sheets under such headings as "Estimated expenses of investigation," "Commissions, brokerage, etc.," "Reinsurance," "Losses and claims," and other items that might fall within the statutory terms "losses," "expenses," and "reinsurance reserves" (R. 80). The Commissioner also allowed the companies to deduct the amounts of premium deposits returned to the policyholders, but he did not allow any deduction on account of premium deposits and income retained by the companies in a so-called contingent reserve account (R. 78–79, 138).

The Board of Tax Appeals sustained the Commissioner, holding that the companies were not exempt from taxation and that they were not entitled to deduct from gross income the annual additions to the "contingent reserve," i. e., those amounts of income, not otherwise deductible, as amounts retained "for the payment of losses, expenses, and reinsurance reserves." The Circuit Court of Appeals affirmed.

In their petitions for certiorari, petitioners apparently do not seek review of the holding that they are not exempt, but appear to contest only the ruling that they were not entitled to the deduction.

ARGUMENT

There is no conflict of decisions and there is no reason for further review of this controversy. The decision below is correct and is not in conflict, as alleged by petitioners, with the Treasury regulations.

Since petitioners do not seem to contest the ruling below that they are not exempt, there remains the problem of classifying them and determining the propriety of the deduction which they seek. Under the revenue acts, insurance companies are divided into three groups: (1) life insurance companies; (2) insurance companies other than life or mutual; and (3) mutual insurance companies other than life. These groups are taxed respectively under Sections 201, 204, and 207 of the Revenue Act of 1934.[3]

If the Government's contention that petitioners are not mutual companies is correct, and if their income must be computed solely under Section 204, then not even petitioners contend that they are entitled to the deduction sought herein.

(1) That petitioners are stock companies rather than mutual companies is clear. The companies were organized as stock companies, and their officers and directors are elected through the Club, its sole stockholder. A substantial minority of the policyholders are not members of the Club

[3] The corresponding provisions under the 1928 and 1932 Acts are in Sections 201, 204, and 208 thereof.

and therefor have no voice in the management of the affairs of the companies. Moreover, a substantial minority of the members of the Club who are not policyholders nevertheless do have a voice in the management of the companies. Although the Board found that it is the "present expectation of the officers of the company" that upon liquidation of the insurance companies, the Club will receive only its investment therein (R. 5), there is nothing to prevent a change of that "expectation" with the consequence that the Club could legally demand all of the assets, including the accumulated profits. In these circumstances, it is plain that the companies are stock companies not only in form, but also in substance.

(2) Petitioners nevertheless contend that they are entitled to have their income computed under Section 207 relating to mutual companies, and they rely upon the provisions of Article 207–5 of Regulations 86, as amended (and corresponding provisions found in Article 1014 of Regulations 74 and 77), which read as follows:

> A stock fire insurance company, operated on the mutual plan to the extent of paying dividends to certain classes of policyholders, may make a return on the same basis as a mutual fire insurance company with respect to its business conducted on the mutual plan.

Petitioners raise sweeping questions as to the validity of these regulations. We respectfully submit that no such sweeping questions are present in this case, first, because the regulations are inapplicable, and second, because petitioners would nevertheless not be entitled to the claimed deduction in any event under Section 207 relating to mutual companies, even if the regulations were applicable.

(a) Wholly apart from the fact that these regulations deal only with a fire insurance company, and therefore could not be applicable to the Casualty Company in any event, they are inapplicable to both companies because they speak of a company "operated on the mutual plan to the extent of paying dividends to certain classes of policyholders." These regulations contemplate that even in a stock company it may be possible to carve out and segregate a portion of the business as being conducted upon a mutual basis. But, as held by the court below, petitioners' business was not conducted on a mutual basis. Large amounts of profit had been permitted to accumulate, and the sole stockholder, as such, was alone entitled to those assets upon dissolution. A substantial number of members of the Club who were not policyholders would benefit indirectly in those circumstances, and indeed, the composition of the Club at the time of any such possible future dissolution might conceivably be such as to embrace

comparatively few of the policyholders whose contributions over the period of years were responsible for the accumulated profits. These companies were not operated upon a mutual basis within the meaning of the regulations, which were intended merely to govern those cases in which a portion of a company's business could be segregated and treated differently. The absence of mutuality here goes to the entire enterprise. The regulations are not applicable, and there is therefore no basis for petitioners' contention that the decision below is contrary to Treasury practice of long standing.

(b) Even if the regulations are applicable and even if it were possible to classify a portion of petitioners' business as "mutual" so as to bring it within Section 207, then petitioners would nevertheless fail to qualify for the deduction sought herein. Section 207 (c) (3) of the 1934 Act provides as follows:[4]

> SEC. 207. MUTUAL INSURANCE COMPANIES OTHER THAN LIFE.
>
> * * * * *
>
> (c) *Deductions.*—In addition to the deductions allowed to corporations by section 23 the following deductions to insurance companies shall also be allowed, unless otherwise allowed—
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> * * * * *

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[4] The corresponding provisions in the 1928 and 1932 Revenue Acts are found in Section 208(c) (3) of those Acts.

> (3) *Mutual insurance companies other than life and marine.*—In the case of mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves.

Petitioners seek to deduct amounts for each year which were added to the so-called contingent reserve and which they assert were amounts "of premium deposits retained for the payment of losses, expenses, and reinsurance reserves." But petitioners have failed to show that the so-called contingent reserve meets these requirements. Petitioners have maintained other adequate reserves for unearned premiums, losses, reinsurance, and other liabilities, and the Commissioner has already allowed appropriate deductions for such reserves. And for aught that may appear the "contingent reserve" is nothing more than a euphemism for an additional surplus account. The net amount added to the "contingent reserve" was merely income remaining after deducting expenses, losses, refunds to policyholders, etc. (R. 23–24, 80–81, 137–138), which might normally be added to surplus available for distribution in the form of dividends to its sole stockholder. True,

no such dividends were paid, but the power to declare them existed then as it presumably continues to exist now, and it is wholly a matter of conjecture as to what will be the ultimate disposition of such funds. Therefore, even if the business of petitioners may be classified as "mutual" under Section 207, pursuant to the regulations, the deduction sought herein is nevertheless not available to petitioners under those provisions.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
ARNOLD RAUM,
J. LOUIS MONARCH,
NEWTON K. FOX,
Special Assistants to the Attorney General.

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